No. 12894

United States
COURT OF APPEALS
for the Ninth Circuit

UNITED STATES OF AMERICA,
Appellant,

v.

PACIFIC ABSTRACT TITLE CO.,
a Corporation,
Appellee.

On Appeal from the United States District Court
for the District of Oregon

BRIEF FOR THE APPELLEE

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STATEMENT

Supplementing the statement made by the Appellant, Appellee wishes to add certain other facts. Pursuant to Sections 101-1501 and 101-1502, O.C.L.A., appellee deposited with the Treasurer of the State of Oregon many years ago securities in the value of $100,000.00. This deposit is a solvency deposit and is wholly unrelated to the reserve now in question (R. 28).

In December, 1945, the Insurance Commissioner of the State of Oregon promulgated a rule ordering title insurance companies to maintain an unearned premium reserve beginning with the calendar year 1942 amounting to 3% of the total gross fees and premiums received. A written copy of this rule was mailed to the Appellee on January 12, 1946, and is as follows:

> "1. The Pacific Abstract Title Company shall establish, segregate and maintain an unearned premium or reinsurance reserve as hereinafter provided, which shall at all times and for all purposes be deemed and shall constitute unearned portions of the premiums and shall be charged as a reserve liability of your corporation in your statements; such reserve shall be cumulative and shall be established and shall consist of the following:
>
> "(a) As at December 31, 1945 or within a period of three years thereafter an amount equal to 3% of the total gross fees and premiums received or to be received on account of policies issued during the four calendar years—1942, 1943, 1944 and 1945; and
>
> "(b) Monthly at the close of each month beginning January, 1946, 3% of the total gross fees and premiums received or to be received on account of policies written during the preceding calendar month;
>
> "(c) After the expiration of 180 months from January 1, 1942, that portion of the unearned premium or reinsurance reserve established more than 180 months prior shall be released and shall no longer constitute part of the unearned premium or reinsurance reserve and may be used for any corporate purposes.
>
> "2. Hereafter the Pacific Abstract Title Company shall segregate and maintain a "Title Loss Reserve" at least equal to the aggregate estimated

amount due or to become due on account of all unpaid losses and claims upon title insurance policies of which the company has received notice but not less than the aggregate of title losses incurred during the immediately preceding 56 months.

"3. Hereafter the Pacific Title Company shall not issue a policy of title insurance for a single transaction, the face amount of which shall exceed an amount which is five times the capital and surplus of your company; but nothing herein shall prevent the Pacific Abstract Title Company from assuming the risk on a single policy jointly with another title insurance company or companies in excess of five times the Pacific Abstract Title Company's capital and surplus, provided that the total amount of such insurance shall not exceed five times the total combined capital and surplus of all such companies liable under such insurance; and provided that each such company shall not assume more than its proportionate share of the total amount at risk in accordance with the above defined maximum retention limit." (R 26, 27) (Plaintiff's Exhibit 1)

This rule applied to all Title Insurance Companies in the State of Oregon. Appellee's books and affairs were examined by the Insurance Commissioner of the State of Oregon in the year 1945 and at the conclusion of this examination Appellee was directed to set up an unearned premium reserve as of December 31, 1945 for the years 1942, 1943, 1944 and 1945 (R 26, 27). On December 26, 1945, this order was made and a letter addressed to the Title and Trust Company (R 27, Plaintiff's Pretrial Exhibit 2).

In December, 1945, officers of the Title and Trust Company exhibited to officers of Appellee the written

rule received by the Title and Trust Company from the Insurance Commissioner.

In December, 1945, Appellee had read the full text of the rule and had actual notice that the rule had been promulgated (R 27).

With this knowledge, Appellee set up on its books a reserve as called for in the order as of December 31, 1945.

POINTS AND AUTHORITIES

I.

The reserve consisted of unearned premiums as that term is used in Section 204 (b) (5) of the Internal Revenue Code.

American Title Co. v. Comm., 76 Fed. 2d 332.

City Title Ins. Co. v. Comm., 152 Fed. 2d 859.

Morgan vs. Comm. of Int. Rev., 309 U.S. 78, 80, 626; 60 S. Ct. 424, 426; 84 L. Ed. 585, 1035.

Section 204 (b (5) of the Internal Revenue Code.

Early v. Lawyers Title Insurance Corp., 132 Fed. 2d 42.

New Hampshire Fire Insurance Co., 2 T. C. 708 Affirmed by Circuit Court of Appeals, 1st Circuit in Comm. of Int. Rev. v. New Hampshire Fire Insurance Co., 146 Fed. 2d 697.

Mass. Protective Assoc. v. U. S., 114 Fed. 2d 304.

Commissioner v. Dallas Title & Guaranty Co., 119 Fed. 2d 211.

Maryland Casualty Co. v. U. S., 251 U.S. 342; 64 L. Ed. 297.

Fidelity & Deposit Co. of Maryland v. U.S.C.C.H. Standard Federal Tax Reporter; 1950 Vol. 5, p. 12, 119 Par. 9106 Affirmed in U.S. v. Fidelity & Deposit Co., 177 Fed. 2d 753.

Solomon S. Huebner Property Ins., Ch. 14, pp. 153, 154.

Title & Trust Co. v. Commissioner, 15 T.C. 510.

ARGUMENT

Appellant admits that companies that insure land titles for a consideration are taxable as insurance companies. (Appellant's Br. 9)

Special statutory provisions have been made with respect to insurance companies other than Life and Mutual. The applicable provisions of Section 204 of the Internal Revenue Code are as follows:

> (b) DEFINITION OF INCOME, ETC. In the case of an insurance company subject to the tax imposed by this section:
>
> (1) GROSS INCOME: "Gross Income" means the sum of (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, and (B) gain during the taxable year from the sale or other disposition of property, and (C) all other items constituting gross income under Section 22; except that in the case of a mutual fire insurance company described in paragraph (1) of subsection (a) of this section, the amount of single deposit premiums paid to such company shall not be included in gross income;

(4) UNDERWRITING INCOME: "Underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;

(5) PREMIUMS EARNED: "Premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year.

For the purposes of this subsection, unearned premiums shall include life insurance reserves, as defined in section 201 (3) (2), pertaining to the life burial, or funeral insurance, or annuity business of an insurance company subject to the tax imposed by this section and not qualifying as a life insurance company under section 201 (b).

The meaning of taxable income, unearned premiums and insurance reserves as applied to insurance companies has been before the courts in many cases.

In *Maryland Casualty Co. vs. U. S.,* 251 U.S. 342, 64 L. Ed. 297, the Court defines reserves to mean:

"A sum of money variously computed or estimated which, with accretions from interest, is set aside 'reserved' as a fund with which to mature or liquidate either by payment or reinsurance future unaccrued and contingent claims; claims accrued but contingent and indefinite as to time or amount of payment. The term includes unearned premium reserve to meet future liabilities on policies".

Solomon S. Huebner, in his work Property Insurance, Chapter 14, Pages 153-154, quoted in respondent's brief, states:

> "This unearned portion of the premium constitutes a reserve. It must be regarded as a sum held in trust by the company for its policyholders. . . . The reinsurance reserve may thus be defined as an 'unearned premium' . . . "

In *Commissioner vs. Dallas Title & Guaranty Company* (CCA 5), 119 Fed. 2d 211, the Court states:

> "It is not impossible for the premium paid a title insurance company to be unearned."

In *Massachussetts Protective Association vs. U. S.,* 114 Fed. 2d 304, quoted with approval in *Early vs. Lawyers Title Insurance Corp.,* 132 Fed. 2d 42, the Court states that a reserve for noncancellable health and accident policies, whether returnable to the insured or not, was not available for the use of the general purposes of the plaintiff but was held as a liability to provide for the payment or reinsurance of specific contingent insurance liabilities and as long as these reserve funds were not to be used for the general purposes of the company, they were not earned premiums within the meaning of Congress and not includable as gross income. The Court stated:

> "The test is not whether the part of the premium set aside in the reserve for non-cancellable health and accident insurance 'belongs' to the company in the event of cancellation or lapsing of the policies, but whether that amount is such a part of the company's gross income as Congress considered should be treated as net income for the purposes of taxa-

> tion. McCoach vs. Insurance Company of North America, supra. We hold that it is not."

In the Massachusetts case, the Commissioner contended that the reserve could not be unearned premiums because if the policy was cancelled, the policyholder received no surrender value and the petitioner kept the excess reserve accumulated. The Court held that nevertheless, the reserves did constitute unearned premiums.

The Court pointed out that the surrender value of life insurance is never the full value of the reserve as a surrender charge is deducted. Upon the cancellation of a fire insurance policy, the total pro-rata share is not repaid to the policyholder as a monthly short-rate is deducted. Therefore, "unearned premium" cannot be tested by what the company must return on cancellation.

In *Early vs. Lawyers Title Insurance Corp.* (supra) (Appendix infra), the appellant contended that earned premiums paid for title insurance are earned when received and that the effect of the statute of Virginia, which required the title company to set up a reserve, was to provide a mere solvency reserve which the company was not entitled to treat as unearned premiums.

The Court, in answering this contention, cited the *Commissioner vs. Dallas Co.* (supra), case with approval and stated:

> "Unquestionably, the premium collected for title insurance is not all clear profit or income to the company immediately upon its receipt. As a matter of fact, there is a time element as well as the element of contract to be considered in connection with the risk assumed in this type of insurance as well as in other

types; and if any portion of the premiums, in consideration of the time element, is given, either by law or contract, the status ordinarily accorded an unearned premium in insurance law during any portion of the period for which the risk is operative, there is no reason why it should not be treated as an 'unearned' premium within the meaning of the taxing statute during this period. We think that the Virginia statute has this effect."

The Insurance Commissioner is not attempting by "legislative fiat" or order to convert earned premiums into unearned premiums. As stated in *Early vs. Lawyers Title Insurance Corp.,* 132 Fed. 2d 42:

> "The sums thus set aside 'at all times and for all purposes' are, by mandate of the statute, to 'constitute unearned portions of the original premiums'. This means that they are not available to the company for its ordinary purposes, until the times limited in the statute have expired, but, until then, are held in trust for the benefit of the contract holders. If the company should in the meantime become insolvent, they would be available as unearned premiums for reinsurance of the contracts, or if not used for that purpose would belong to the contract holders". Citing cases.

And again:

> "We agree that a statute of the state could not be given the effect of withdrawing from taxation under the Revenue Act what was in fact an earned premium by the mere device of calling it unearned; but the Virginia statute does more than this. It gives to the portions of the premiums which it requires to be placed in the reserve all of the attributes that pertain to unearned premiums, i.e., it withdraws them from the power of the company to use them for its general purposes and impresses them with a trust in favor of contract holders until the risk shall have been carried

> for the period that the statute prescribes. . . . Until then, the company cannot be truly said to have earned the portion of the premium which the law requires it to reserve and hold in trust during this crucial period of risk".

It was also contended in the Early case that the term "unearned premiums" in the taxing statute must be given its ordinary meaning. Again the Court said:

> "This is undoubtedly correct; but so also must the term as used in statute of Virginia, and when given that meaning there its effect is to impress upon the portions of the premiums reserved the characteristics which bring them within the meaning of the term as used in the taxing statute."

State law creates legal interests and rights. The federal revenue acts designate what interests or rights so created shall be taxed. *Morgan vs. Commissioner of Internal Revenue,* 309 U.S. 78, 80, 626; 60 S. Ct. 424, 426; 84 L. Ed. 585, 1035.

Respondent contends that Congress in enacting Section 204 (b) (5), of the Internal Revenue Code made no provision in the case of an insurance company, other than life or mutual, for the deduction of any reserve whatever (page 19, Respondent's Brief). This same argument was advanced in *Massachusetts Protective Association vs. U. S.* (supra), where it was argued that the reserve was not to be added to the unearned premium in computing gross income because Congress, in 1926 made no provision for the deduction from the gross premiums of insurance companies other than life or mutual of the net addition to the reserve funds required by law which had been allowed all insurance companies prior to 1921.

The Court, in answer to this argument, stated that no departure had been made by Congress from the previous system of taxing only earned premiums of insurance companies. The Court stated that deduction of net addition to reserve funds required by law is not prevented if the addition represents unearned premiums.

The case of *Early vs. Lawyers Title Insurance Corp.* (supra) is a leading case with reference to reserves set up by title insurance companies. All the contentions now presented by the Appellant in this case were presented in the Early case. In the case before the Court, the rule of the Oregon Insurance Commissioner had the same effect as the Virginia statute in the Early case. The Commissioner in said rule recognized the time element as well as the element of contract in connection with the risk assumed.

That portion of the premiums, in consideration of the time element of the risk, which the Insurance Commissioner's rule gave the status ordinarily accorded an unearned premium in insurance law for the period designated in the rule should be treated as unearned premiums within the meaning of the taxing statute during this period.

A portion of the income of the Appellee was placed in reserve and frozen for a period of time and was not available for general corporate purposes. Eventually, after the expiration of the 15-year period referred to in the Insurance Commissioner's rule, the unused reserves will become available to the company as earnings without any restriction as to their use and will then become part of

the income of the corporation for income tax purposes.

The premium is not wholly earned at the time it is paid even though no part of the premium is returnable to the policyholder upon cancellation. There is a liability on the title insurance policy which gradually diminishes during the passage of time by reason of the statute of limitations and other rules of law which cure defects in the title. The test of an unearned premium is whether or not a portion of the premium is withdrawn from the power of the company to use for its general purposes until the time limited by law has expired. If the premium is not permanently withdrawn, then the portion held in the reserve is an unearned premium and is not taxable as income until it is available to the company for general corporate purposes.

The rule of the Insurance Commissioner of Oregon requiring an unearned premium reserve does not freeze these funds permanently. After the expiration of the 15-year period, if the unearned premiums have not been used for the benefit of the policyholders for whom the premiums were set aside, they then become earned and become taxable income to the company. In the meantime, however, they are held as a trust fund for the benefit of the policyholders until such times as they become released by the order of the Insurance Commissioner. This fund has all the attributes of an unearned premium reserve allowable under Section 204 of the Internal Revenue Code, and, therefore, it is an unearned premium reserve.

In *American Title Company vs. Commissioner,* 76 Fed. 2d 332, reserves were set up by the company for the protection of policyholders as required by the laws of Pennsylvania and this reserve fund was deducted from gross income on the federal tax return of the company. The Court held that the reserves were not deductible. Under the Pennsylvania statute, the reserves were not to be returned until the last outstanding policy of the company had expired. There was a permanent freezing of the funds and for this reason the Court held this to be an insolvency fund and not an unearned premium reserve.

In the case of *City Title Insurance Co. vs. Commissioner,* 152 Fed. 2d 859, a similar ruling was made with respect to unearned premiums set up under the New York statute. The New York statute did not provide for the return of the reserves to the insurance company. Whether the reserves are to be returned to the company or permanently set aside is the determining factor in this case. (In the opinion of the Court, reference was made to the *American Title Co.* case, and the case of *Early vs. Lawyers Title Insurance Co.,* 132 Fed. 2d 42, infra.) In the *City Title Insurance Company* case, the deduction of reserves was claimed for the years 1938 to 1941 inclusive. From the Court's decision, it is apparent that the New York statute was amended in 1945 to apply to unearned premium reserves and reinsurance reserves to be held for a limited time of 180 months. The Court did not attempt to decide the effect of the amendment as the taxes involved were all prior to the time of the amendment. However, no further question has been

raised by the Commissioner as to deductions for reserves under the amended New York statute, which amended New York statute is similar to the Virginia statute construed in the Early case, supra.

It would seem that the Court would take judicial knowledge of the fact that the population in the West has greatly increased in the last nine years, and also of the fact that there has been a very great increase in the value of real property in the same period of time. Inasmuch as title insurance companies insure the full value of the property, this increase in values has increased their liabilities enormously. For these reasons, the Insurance Commissioner of the State of Oregon evidently deemed it advisable to promulgate this rule in 1945 setting up an unearned premium reserve for the benefit and protection of title insurance policyholders and for the public good.

I wish to point out to the Court that this is not an insolvency reserve because, as stated before, Appellee has already deposited many years ago, securities in the value of $100,000.00 as a solvency reserve. The Commissioner, in the exercise of his administrative discretion, evidently considered it necessary to set up this reserve for the protection of the policyholders themselves.

POINTS AND AUTHORITIES

II.

The delegation of the power to determine the amount of the unearned premiums on a pro rata basis and the amount necessary as a reserve to provide for the future payment of deferred and undetermined claims is a valid delegation of legislative power and the order of the Insurance Commissioner of Oregon fixing the amount of the unearned premium reserve to be reserved by Appellee is within the limits of the power so delegated.

Section 101-105, O.C.L.A., Subdiv. (1), (2).

Section 101-107, O.C.L.A., Subdiv. (7).

Section 101-136, O.C.L.A.

Section 101-137, O.C.L.A.

Field vs. Clark, 143 U.S. 649.

Hampton & Co. vs. U. S., 276 U.S. 394, 72 L. Ed. 624, 48 S. Ct. Rep. 348.

U. S. vs. Rock Royal Cooperative, Inc., 307 U.S. 533, 83 L. Ed. 1446.

Maryland Casualty Co. vs. U. S., 251 U.S. 342, 64 L. Ed. 297.

State vs. Terwilliger, 141 Or. 372, 11 Pac. 2d 552, 16 Pac. 2d 651.

Savage vs. Martin, 161 Or. 660, 91 Pac. 2d 273.

White vs. Mears, 44 Or. 215, 74 Pac. 931.

State vs. Briggs, 45 Or. 366, 77 Pac. 750.

Fidelity & Deposit Company of Maryland vs. U. S. (Unreported, but may be found in C.C.H. Standard Federal Tax Reporter, Vol. 5, p. 12, 119 Par. 9106.)

Affirmed U. S. vs. Fidelity & Deposit Co., 177 Fed. 2d 805, Rehearing denied 178 Fed. 2d 753.

New Hampshire Fire Insurance Co., Affirmed, Commissioner of Internal Revenue vs. New Hampshire Fire Insurance Company, 146 Fed. 2d 697.

Cancilla vs. Gehlhar, 145 Or. 184, 27 Pac. 2d 179.

11 Amer. Jur. 945, Sections 232 through 237.

11 Amer. Jur. 955, Sections 240 and 241.

The statutes of Oregon defining the duties and powers of the Insurance Commissioner of Oregon are set out in full in the Appendix.

Pursuant to these statutes the Insurance Commissioner of Oregon made an extensive examination into the business conditions of the Appellee. The order of the Insurance Commissioner directing that an adequate unearned premium reserve be provided is the result of his study and analysis of the statutes of the various states, the trend and experience of the Appellee, the premium volume, and the size and types of risks underwritten. The reserve which he ordered to be set up was the result of an actuarial study made by the Insurance Commissioner of the State of Oregon. This is not a permanent reserve, but is only to be held for a period of 180 months and thereafter will become freed again for general corporate purposes.

In the evolution of law, it has been determined that certain powers and duties may be delegated by the legislative body to an executive officer or administrative agency, including the right to make such rules and reg-

ulations as may be necessary to carry out the primary general laws enacted by the legislature. 11 Amer. Jur. 945, Section 232 through Section 237; 11 Amer. Jur. 955, Section 240 and Section 241.

The Appellant contends that the insurance laws of Oregon contain an improper delegation of legislative power to an administrative official and that the directive of the Oregon Insurance Commissioner transcended the power which the legislature delegated to him (Appellant's Br. 18, 20).

Under the authorities in Oregon and in the United States Courts, we believe the Appellant is in error in its contentions. In *U. S. vs. Rock Royal Cooperative, Inc.,* 307 U.S. 533, the act delegating authority to the Secretary of Agriculture to establish marketing areas was held valid. The Court laid down two tests: (1) does the act state the purpose which Congress seeks to establish; and (2) does the act state standards of sufficient exactness to enable those affected to understand the limits. It is submitted that the insurance statutes of the State of Oregon meet these tests and the delegation of authority to the Insurance Commissioner of Oregon is valid and constitutional. The rule of the Insurance Commissioner is reasonable and a valid exercise of this rule making authority.

O.C.L.A., Section 101-105 (1) provides that the Insurance Commissioner shall issue such department rulings, constructions and orders as he may deem necessary to secure the enforcement of the provisions of the Act. It is further provided that the Insurance Commissioner

may revoke the certificate of authority of an insurance company for failing to comply with the laws of the state and regulations of the Insurance Department (O.C.L.A. Sec. 101-107 (7). This statute further provides for examination of insurance companies to ascertain the condition of such companies and states:

> "In determining the amount of such reserve or unearned premium liability, the Insurance Commissioner, his deputy or examiner, may formulate such rules as he may deem proper and consistent with law, or he may adopt such rules as are used in other states and approved by the National Convention of Insurance Commissioners." (O.C.L.A. Sec. 101-136)

O.C.L.A., Sec. 101-137 delegates to the Insurance Commissioner the power to determine a formula upon which to calculate the portion of the premiums of insurance companies which is unearned and which is to be set aside as a reserve to provide for the future payment of deferred and undetermined claims for losses and promised benefits.

The statutes of Oregon, therefore, provide that the Insurance Commissioner shall set up an unearned premium reserve and the statutes further provide that the Insurance Commissioner shall determine the amount of such reserve in the exercise of his administrative duties after examination of the companies involved. Experience has proven that in the exercise of the functions of government, certain determinations within the general framework of a law must be delegated to an administrative agency which makes the necessary rules and regulations after and as the facts are determined.

In *Maryland Casualty Co. vs. U. S.,* 251 U.S. 342, 64 L. Ed. 297, the Court held that reserves required by rules and regulations of state insurance departments promulgated in the exercise of an appropriate power conferred by statute were deductible. The Court states:

> "A regulation by a department of government addressed to and reasonably adopted to the enforcement of an act of Congress, the administration of which is confined to such department, has the force and effect of law if it be not in conflict with express statutory provision. (citing cases) The law is not different with respect to the rules and regulations of a department of a state government."

In *Cancilla vs. Gehlhar,* 145 Or. 185, the Court states:

> "A legislature in enacting a law complete in itself, designed to accomplish the regulation of particular matters falling within its jurisdiction, may expressly authorize an administrative commission within definite valid limits to provide rules and regulations for the complete operation and enforcement of the law within its expressed general purpose." (Citing cases)

In the case of *Savage vs. Martin,* 161 Or. 660, the Court states:

> "The legislature can not delegate its power to make a law, but it can make a law to delegate a power to determine some fact or state of things upon which the law makes, or intends to make, its own action depend. . . . There are many things upon which wise and useful legislation must depend, which cannot be known to the law making power, and must, therefore, be a subject of inquiry and determination outside of the halls of legislation."

This is just what the laws of Oregon do provide—that the Insurance Commissioner shall set up for insurance companies an adequate reserve covering unearned premiums computed on a pro rata basis and in such an amount as may be found necessary to provide for the future payment of deferred and undetermined claims for losses and promised benefits. The Legislature further directed the Commissioner to set aside such an amount as may be found necessary as a reserve to provide for the future payment of deferred and undetermined claims and authorized the Commissioner to formulate the necessary rules for determining the amount of such reserve. The Legislature delegated to the Insurance Commissioner the power to investigate the condition and affairs of each insurance company in order to fix as a liability a sum equal to the total unearned premiums and the Legislature authorized the Commissioner to formulate the necessary rules for determining the amount of such unearned premium liability. In other words, all that was delegated to him was the delegation of power to determine the facts upon which to base his action. It is quite apparent the Insurance Commissioner of Oregon took into consideration the fact that title insurance companies in this area were assuming liabilities far in excess of those which had been assumed in previous years and the fact that it was necessary that said companies carry a reserve in addition to the solvency deposit to cover these increase liabilities under the title insurance policies issued in the last several years. Additional reserves were necessary to protect the policyholders. The Insurance Commissioner apparently with wisdom and foresight

felt that the growth of the community and extent of liability on title insurance policies would increase rather than decrease, having in mind that all property values in the country had greatly increased, and particularly so in the Pacific Northwest. Title insurance policies are premised upon the full value of the property.

From the various cases cited, it can plainly be seen that the Insurance Commissioner did not exceed the power conferred upon him by the Legislature and in his directive the words "unearned premiums" are used in their ordinary sense as stated in the Early case, supra. The term "unearned premiums" used in the Virginia statute was used in its ordinary sense and the same is true in the rule promulgated by the Oregon Insurance Commissioner.

The Appellant argues that the power to determine the amount of the unearned premium reserve delegated to the Insurance Commissioner is an unconstitutional delegation of legislative power (Appellant's Br. 22).

The Appellant also argues that the Insurance Commissioner, in setting up the amount of the unearned premium reserve, acted outside and beyond the power delegated by the Legislature (Appellant's Br. 18, 20).

These arguments are based on Appellant's premise that there is no such thing as "unearned premiums" in the title insurance business because the policyholder has no claim against the company for the return of any portion of his premium (Appellant's Br. 15).

But the Courts hold that the test of an unearned premium is not whether the policyholder is entitled to

the return of a portion of the premium, but whether a portion of the premium is withdrawn from the power of the Company to use for its general purposes until the time limited by law has expired and until then is impressed with a trust for the benefit of the policyholder.

Therefore, Appellant's entire argument is based on a fallacious premise and the rule of the Insurance Commissioner is a valid exercise of the power delegated to him by the Legislature. After investigation the Commissioner determined the amount of the reserve necessary. This determination is a valid administrative act and the delegation of the power to make an investigation and to so determine is a valid delegation of power.

POINTS AND AUTHORITIES

III.

The reserve was properly excluded from taxable income and accrued as a liability of Appellee in 1945.

Early vs. Lawyers Title Ins. Corporation, 132 Fed. 2d 42.

U. S. vs. Anderson, 46 Supr. Ct. Rep. 131.

Lucas vs. American Code Co., 280 U.S. 445, 50 S. Ct. 202, 74 L. Ed. 538, 67 A.L.R. 1010.

Lucas vs. Ox Fibre Brush Co., 281 U.S. 115, 50 S. Ct. 273, 74 L. Ed. 733.

U. S. vs. Anderson, 269 U.S. 422.

American National Co. vs. U. S., 274 U.S. 99, 47 S. Ct. Rep. 520, 71 L. Ed. 946.

Spring City Foundry Company vs. Commissioner, 292 U.S. 182, 78 L. Ed. 1200.

Security Flour Mills Company vs. Commissioner, 321 U.S. 281, 64 S. Ct. 596, 88 L. Ed. 725.

Commissioner vs. Blaine, Mackay, Lee Co., (CCA 3), 141 Fed. 2d 201.

Central Trust Co. vs. Burnet (CCA-DC), 45 Fed. 2d 992.

The Appellant contends that there could be no accrual of any funds for previous years for the reason that the premium had been determined and no unearned premium had been set aside. We submit to the Court that this argument is not sound. The Appellee, pursuant to the order of the Insurance Commissioner, deducted a sum of money from its surplus and set it up as a reserve as of December 31, 1945. This was based upon a percentage of premiums received in previous years, but the funds were taken out of the funds of the company in 1945. This question was decided in *Early vs. Lawyers Title Ins. Corp.,* 132 Fed. 2d 42, where the Court at page 46 says:

> "We were disturbed upon the argument because the deduction of the reserve resulted in what seemed to be a distortion of the income of the company for the year 1936. Further consideration convinces us that the position of the company with respect thereto is correct. Under the language of the Revenue Act there is no authority for adding to premiums received during 1936 any part of the reserve held at the end of the preceding year, as none of this reserve had been given the status of unearned premiums. The passage of the Virginia statute unquestionably resulted in funds to the amount of the reserve at the end of the year being withdrawn from the unfettered control of the company and being held in trust for the benefit of contract holders; and the practical affect of this was to decrease by such

> amount the income of the year available for ordinary purposes. Furthermore, income tax had already been paid on the amount held in reserve prior to the passage of the statute; and, to add any part of this amount to the premiums collected in the year 1936, for the purpose of determining underwriting income for that year, would result in its being taxed twice. The amount deducted as unearned premiums does not, of course, escape taxation, since it is subjected to tax as it is released from the reserve pursuant to the provisions of the statute.

In that case, the same situation existed as in this case. The Court decided that the passage of the Virginia statute resulted in funds to the amount of the reserve at the end of the year being withdrawn from the unfettered control of the company and beind held in trust for the benefit of contract holders; and the practical effect of this was to decrease by such amount the income of the year available for ordinary purposes. The rule of the Insurance Commissioner of Oregon has the same effect as the Virginia statute.

Under the income tax statutes where a taxpayer is on the accrual basis, items of income are reported in full in the year in which they are earned. On the other hand deductions or liabilities ordinarily cannot be taken or deducted until they become fixed or certain, and sometimes by an identifiable event. In this case, the liability which resulted in the reserve of income for unearned premiums arose with the order of the Insurance Commissioner of Oregon as set forth in letter dated December 26, 1945 to the Title and Trust Company, and it was at that time that the liability became fixed and the plaintiff knew that a reserve would have to be set up. A case

somewhat similar in its holding is the case of *U. S. vs. Anderson,* 46 Supr. Ct. Rep. 131, wherein all of the facts as to a munition tax was known in one year but the tax was not paid until the following year. The Court, however, held that the accrual should have been made in a prior year. The Court stated:

> "In a technical sense, a tax does not accrue until it has been assessed and becomes due, but it is also true that in advance of the assessment of a tax, all the events may accrue which fix the amount of the tax and fix the amount of the liability of the taxpayer to pay it. In this respect for the purposes of accounting and of ascertaining a true income for a given accounting period, the munition tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books."

In *Lucas vs. American Code Co.,* 280 U.S. 445, 50 S. Ct. 202, 74 L. Ed. 538, 67 A.L.R. 1010, the United States Supreme Court held that damages for breach of a contract of employment recovered against a taxpayer accounting on the accrual basis are not deductible in the year in which the breach occurred where the amount was not determined or paid until later and which was contested and the amount was wholly unpredictable until the litigation was ultimately brought to a close.

Following this case the Supreme Court decided the case of *Lucas vs. Ox Fibre Brush Co.,* 281 U.S. 115, 50 S. Ct. 273, 74 L. Ed. 733, wherein a corporation was granted extra compensation to its officers for services performed in prior years. The United States Supreme Court held that even though this payment was for services in prior years, it was a proper deduction in determin-

ing the taxable income of the corporation for the year in which the grant was made even though the books of the corporation were kept on an accrual basis. In its opinion, the Court referred to the sections of the income tax statute with respect to computing net income and stated as follows:

> "This section relates to the method of accounting; the commissioner may make the computation on a basis that does clearly reflect the income, if the method employed by the taxpayer does not. But this section does not justify the commissioner in allocating to previous years a reasonable allowance as compensation for services actually rendered, when the compensation was properly paid during the taxable year and the obligation to pay was incurred during that year and not previously. In the present instance, the expense could not be attributed to earlier years, for it was neither paid nor incurred in those years. There was no earlier accrual of liability. It was deductible in the year 1920 or not at all. Being deductible as a reasonable payment, there was no authority vested in the commissioner to disregard the actual transaction and to readjust the income on another basis which did not respond to the facts."

Deductions should be accrued when all events have occurred which fix the liability, even though the amount be then uncertain. The accrual system wholly disregards due dates. Neither is it necessary that the amount of an incurred liability be accurately ascertained in order to "accrue" it. *U. S. vs. Anderson,* 269 U.S. 422. *American National Co. vs. U. S.,* 274 U.S. 99, 47 S. Ct. Rep. 520, 71 L. Ed. 946.

The accrual of a reserve to cover liability for unearned premiums is in the general category of other

deductions and not entirely unlike the reasoning which is applied to debts ascertained to be worthless and charged off. The right to take a deduction only exists in a year in which it becomes fixed or determined as pointed out by the Supreme Court in *Spring City Foundry Company vs. Commissioner,* 292 U.S. 182, 78 L. Ed. 1200. This principle was further enunciated by the Supreme Court in *Security Flour Mills Company vs. Commissioner,* 321 U.S. 281, 64 S. Ct. 596, 88 L. Ed. 725, where the Court said:

> "This legal principle has often been stated and applied. The uniform result has been denial both to Government and to the taxpayer of the privilege of allocating income or outgo to a year other than the year of actual receipt or payment, or, applying the accrual basis, the year in which the right to receive, or the obligation to pay, has become final and definite in amount."

In the case of *Commissioner vs. Blaine, Mackay, Lee Co.* (CCA 3), 141 Fed. 2d 201, the Court said:

> "Under the accrual system (here in use) income is accruable in the year in which the taxpayer's right thereto becomes fixed and definite, even though it may not be actually received until a later year, while a deduction for a liability is to be accrued and taken when the liability becomes fixed and certain, even though it may not be paid until a later year."

See also *Central Trust Co. vs. Burnet* (CCA-DC), 45 Fed. 2d 992.

The record already shows that Appellee had been informed by the Insurance Commissioner and his Deputy that a reserve would have to be set up, in a certain

amount, in a certain year (during the year 1945) and that all of the title insurance companies in the State of Oregon would have to set up the same reserve (R. 27). The order was promulgated December 26, 1945 in the letter to the Title and Trust Company (Plaintiff's pretrial Exhibit 2) and Appellee's officers were cognizant of this order and immediately proceeded to comply with it for the end of the year of 1945 (R. 28).

We wish to call the Court's attention to another feature of this case. Appellee attempted to file amended returns for the years 1942, 1943 and 1944 with the Internal Revenue Department claiming a portion of the amount of this reserve for each of these years. The Collector of Internal Revenue denied the Appellee the right to do this (Plaintiff's Exhibit 8).

CONCLUSION

The Appellee is an insurance company under the Insurance Code of the State of Oregon and is under the jurisdiction of the Insurance Commissioner of the State of Oregon and subject to all the insurance laws of the State of Oregon. The unearned premium reserve was properly set up by the rules and regulations of the State Insurance Department under the exercise of an appropriate power conferred by statute. In this case, the Insurance Commissioner of the State of Oregon, under the insurance laws, was given the power to promulgate the rule or order which was made and there was no unreasonable delegation of authority by the legislature. The rule was not arbitrary or capricious, but was based wholly upon complete examination and valuation of the circumstances. The reserve for unearned premiums as set up by the Appellee was given by the order promulgated by the Insurance Commissioner of the State of Oregon, the status ordinarily accorded an unearned premium in insurance law.

There is a time element as well as the element of contract to be considered in connection with the risk assumed in this type of insurance as well as in other types. There is no reason why it should not be treated as unearned premium within the meaning of the taxing statute during the period that it is reserved. The order of the Insurance Commissioner of Oregon has the effect of making it an unearned premium reserve. This is not a solvency reserve and it is not a permanent reserve, for at the end of 180 months a portion of the reserve fund

returns to the corporation surplus and thereafter each year a like portion of the reserve fund returns to the corporation to be used for general purposes and taxable as income. The reserve fund was properly set up by the Appellee in the year 1945 because it was in the year 1945 that the amount became fixed and determined. Also, at that time the funds were withdrawn from the control of the corporation and were placed in a trust fund for the benefit of the policyholders and the practical effect of this was to decrease by such amount the income of that year available for ordinary purposes.

We, therefore, submit to the Court that the decree of the District Court of the United States for the District of Oregon in favor of the Appellee was just and proper and should be affirmed.

Respectfully submitted,

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WM. J. MASTERS,
Attorneys for Appellee.

APPENDIX

"SECTION 101-105, O.C.L.A., SUBDIVISION (1). The insurance commissioner shall have and exercise the power to enforce all the laws of the state relating to insurance, and it shall be his duty to enforce all the provisions of such laws for the public good. *He shall issue such department rulings, instructions and orders as he may deem necessary to secure the enforcement of the provisions of this act,* but nothing contained in this act shall be construed to prevent any company or persons affected by any order or action of the insurance commissioner from testing the validity of same in any court of competent jurisdiction."

"SECTION 101-105, O.C.L.A., SUBDIVISION (2). (Issuance of certificates, etc.) He shall issue all certificates and licenses under the seal of his office provided for by the terms of this act. Before granting certificates of authority to any insurance company to issue policies or make contracts of insurance in this state, the commissioner shall be satisfied by such examination as he may make, or such evidence as he may require, that such company is duly qualified under the laws of this state to transact business herein."

"SECTION 101-107, O.C.L.A., SUBDIVISION (7). CERTIFICATE OF AUTHORITY OF DOMESTIC COMPANIES. *A domestic insurance company shall be granted a certificate of authority* to transact any kind or class of insurance permitted by the provisions of the insurance laws of this state and provided for in its articles of incorporation upon its compliance with the laws of this state and the regulations of the insurance department relating to such companies and the payment of the fees and charges imposed by law, *which certificate may be*

revoked on thirty (30) days' notice by the insurance commissioner, or he may suspend same temporarily if he deems necessary or advisable. Cause for revocation or suspension of such certificate shall exist if its capital is found to be impaired or the required surplus has not been maintained or if *its transactions have been found to be in violation of the law."*

"SECTION 101-136, O.C.L.A. (Examination into affairs of company or persons in insurance business: Appointment of examiners: Duty to produce books and papers and to facilitate examination: Report of examiners: Hearing: Inspection and publication of report: Expenses of examination.) *The insurance commissioner shall, whenever he deems it advisable in the interest of policyholders or for the public good, examine into the affairs of any insurance company,* agency, corporation, partnership, person or persons engaged in or proposing to engage in the insurance business in this state, and into the affairs of any company organized under any laws of this state or having an office or representative in this state, which company is engaged in or is claiming or advertising that it is engaged in organizing or receiving subscriptions for or disposing of stock of, or in any manner aiding or taking part in the formation or business of an insurance company or companies, or which is holding capital stock of one or more insurance companies for the purpose of controlling the management thereof as voting trustee or otherwise. For such purpose he may appoint as examiners one or more fair, impartial and competent persons, not officers of, nor connected with nor interested in any insurance company, other than as policyholders, nor in any other company above referred to, and upon such examination, he, his deputy or any examiner authorized by him may examine under oath the officers and agents of such company or agency and all persons deemed to have material information regarding the property or

business of such company or agency. Every such company or agency, its officers and agents, shall produce at the office of the company or agency where the same are kept its books and all papers in its or their possession relating to its business or affairs, and any other person may be required to produce any book or paper in his custody relevant to the examination, for the inspection of the insurance commissioner, his deputies or examiners whenever required; and the officers and agents of such company or agency shall facilitate such examination and aid the examiners in making the same so far as it is in their power to do so. Every such examiner shall make a full and true report of every examination made by him, verified by his oath, which shall comprise only facts appearing upon the books, papers, records or documents of such company or agency or ascertained from the testimony sworn to of its officers or agents or other persons examined under oath concerning its affairs, and said report so verified shall be presumptive evidence in any action or proceeding in the name of the people against the company or agency, its officers or agents, of the facts stated therein. The insurance commissioner shall grant a hearing to the company or agency examined before filing any such report and before making public such report or any matters relating thereto; and may withhold such report from public inspection for such time as he may deem proper; and if said company or agency offers no objection at said hearing, it will be an admission of acceptance; and may, after so filing, if he deems it for the interest of the public to do so, publish any such report of the result of any such examination as contained therein in one or more newspapers of the state without expense to the company or agency. Any company or association doing business in Oregon shall pay the just and legitimate expenses, including railroad fares and traveling expenses of any examination; and the commissioner shall revoke or

refuse his certificate of authority to any company neglecting or refusing to pay such expenses, or neglecting or refusing to furnish any information to said commissioner. It shall be the duty of the insurance commissioner to examine every domestic insurance company at least once in three years."

"SECTION 101-137, O.C.L.A. Examination: Reserve: Liability: (Formulating or adopting rules). In ascertaining the conditions of an insurance company under the provisions of this act, or in any examination made by the insurance commissioner, his deputy or examiner, he shall allow as assets only such investments, cash and accounts as are authorized by the laws of this state at the date of the examination, or under the laws of the state or country under which such company is organized and which investment he may approve or reject, but unpaid premiums on policies written within three months shall be admitted as available resources. *In ascertaining his liabilities,* unless otherwise provided in this act, *there shall be charged* the capital stock, all outstanding claims, *a sum equal to the total unearned premiums on the policies in force computed on a pro rata basis, and such an amount as may be found necessary as a reserve to provide for the future payment of deferred and undetermined claims for losses and promised benefits. In determining the amount of such reserve or unearned premium liability, the insurance commissioner, his deputy or examiner may formulate such rules as he may deem proper and consistent with law or he may adopt such rules as are used in other states or approved by the national convention* of insurance commissioners."

In the case of *Early vs. Lawyers Title Ins. Corp.,* 132 Fed. 2d 42, Mr. Justice Parker speaking for the Court, held:

"The contention of the appellant is that premiums paid for title insurance are earned when received, that there is no basis for treating any part of such premiums as unearned and that the effect of the statute of Virginia is to provide a mere solvency reserve which the company is not entitled to treat as unearned premiums. Appellant is undoubtedly correct in the position that ordinarily a premium paid for title insurance is to be treated as fully earned when received. *American Title Co. v. Commissioner of Internal Revenue,* 3 Cir., 76 Fed. 2d 332; Huebner on Property Insurance, p. 493. And in the absence of the Virginia statute replied on by the company we should feel constrained to hold that no part of the premiums received for title insurance could be treated as 'unearned' within the meaning of the section of the Revenue Act above quoted.

"As said by the Circuit Court of Appeals of the 5th Circuit in *Commissioner of Internal Revenue v. Dallas Title & Guaranty Co.,* 119 Fed. 2d 211, 213, however, 'it is not impossible for premiums paid a title insurance company to be unearned'. Unquestionably the premium collected for title insurance is not all clear profit or income to the company immediately upon its receipt. As a matter of fact, there is a time element as well as the element of contract to be considered in connection with the risk assumed in this type of insurance as well as in other types; and if any portion of the premiums, in consideration of the time element, is given, either by law or contract, the status ordinarily accorded an unearned premium in insurance law during any portion of the period for which the risk is operative, there is no reason why it should not be treated as an 'unearned' premium within the meaning of the taxing statute during this period. We think that the Virginia statute has this effect.

"The liability under a title insurance policy, which in the case of this company is shown under

the law of averages to be around 6% of the premiums collected, is outstanding as a continuing liability of the company to the policyholders; and, in recognition of this fact, the Virginia statute requires that a certain portion of the premiums, 10%, be set aside and held intact for a period of time for the discharge of this liability. The sums thus set aside 'at all times and for all purposes' are, by mandate of the statute, to 'constitute unearned portions of the original premiums'. This means that they are not available to the company for its ordinary purposes, until the times limited in the statute have expired, but, until then, are held in trust for the benefit of the contract holders. If the company should in the meantime become insolvent, they would be available as unearned premiums for reinsurance of the contracts, or if not used for that purpose would belong to the contract holders. *Johnson v. Button,* 120 Va. 339, 91 S.E. 151, 153; *Lovell v. St. Louis Mutual Life Ins. Co.,* 111 U.S. 264, 274; 4 S. Ct. 39, 23 L. Ed. 423; 32 C.J. p. 1040.

"There is no reason why the legislature may not thus require the company to deal with a portion of the premiums collected, just as, in the absence of contract between the parties, it may provide how the policy is to be valued for the purpose of setting up a reserve. Cf. 32 C. J. 1017; *Elder v. Bankers' Life Ins. Co.,* 117 App. Div. 722, 102 N.Y.S. 702. If the statute had provided that 10% of the premiums collected should be held for the benefit of policyholders for a fixed period and should belong to the company only after it had carried the liability for that period, it would hardly be contended that this portion of the premiums was earned within the meaning of the Revenue Act until the expiration of the period; but this is precisely the effect of the Virginia statute in providing that the sums required to be placed in reserve 'shall at all times and for all purposes be considered and constitute unearned portions of the original premiums'.

"Very much in point is the decision of the Circuit Court of Appeals of the First Circuit in *Massachusetts Protective Ass'n. v. United States,* 1 Cir., 114 F. 2d 304, 213. That case involved the right to deduct as unearned premiums a reserve required by law to be kept by an accident and health insurance company. In that case, as in this, there was no provision for cancellation or for return of any part of the premium to the insured. In upholding the right to deduct this reserve as unearned premiums, notwithstanding that there was no requirement that anything be returned to the policyholder, the court said:

" 'Congress is only interested in determining what part of a company's gross income should be treated as net income for the purposes of taxation. *McCoach v. Insurance Co. of North America,* 1917, 244 U.S. 585, 37 S. Ct. 709, 61 L. Ed. 1333. In general, premium income is not such, and its inclusion in gross income is only justified by the deductions allowed. See Hearings before the Committee on Ways and Means on the Revenue Act of 1918, 65th Cong., 2nd Sess., Pt. 1 (1918) 811. The additional reserve for non-cancellable health and accident policies, whether returnable to the insured or not, is not available for the use of the general purposes of the plaintiff. It is held as a liability to provide for the payment or reinsurance of specific contingent insurance liabilities proven by experience to be a part of the cost of this particular type of insurance in the future years. * * * As long as these reserve funds must be held to provide for expected insurance liabilities in the future on these non-cancellable health and accident policies and are not to be used for the general purposes of the company, they are not "earned premiums" within the meaning of Congress and not includible in gross income. The test is not whether the part of the premium set aside in the reserve for non-cancellable health and accident insurance "belongs" to the company in the event of cancellation or lapsing of the policy, but

whether that amount is such a part of the company's gross income as Congress considered should be treated as net income for the purposes of taxation. *McCoach v. Insurance Co. of North America, supra.* We hold that it is not.' "

"We were disturbed upon the argument because the deduction of the reserve resulted in what seemed to be a distortion of the income of the company for the year 1936. Further consideration convinces us that the position of the company with respect thereto is correct. Under the language of the Revenue Act there is no authority for adding to premiums received during 1936 any part of the reserve held at the end of the preceding year, as none of this reserve had been given the status of unearned premiums. The passage of the Virginia statute unquestionably resulted in funds to the amount of the reserve at the end of the year being withdrawn from the unfettered control of the company and being held in trust for the benefit of contract holders; and the practical effect of this was to decrease by such amount the income of the year available for ordinary purposes. Furthermore, income tax had already been paid on the amount held in reserve prior to the passage of the statute; and, to add any part of this amount to the premiums collected in the year 1936, for the purpose of determining underwriting income for that year, would result in its being taxed twice. The amount deducted as unearned premiums does not, of course, escape taxation, since it is subjected to tax as it is released from the reserve pursuant to the provisions of the statute."